Testimony of
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"Electric Utility Industry Restructuring: The California Market"

Overview

I thank the Committee for the honor of testifying here this morning. What brings us all here this morning, specifically, is the topic of recent price increases for the supply of electricity in Southern California. I applaud the Committee for listening to testimony on this topic, as it has extreme significance to the future of competition in electricity markets, wholesale and retail, in Southern California and in the rest of the United States.

I am greatly disturbed by recent events in California energy markets. It is truly a disgrace that San Diego ratepayers now face electricity bills that are double or triple those that they paid last summer. No one should have to face the decision whether to pay for electricity service, on the one hand, and groceries or prescription drugs, on the other. Something is clearly wrong. I take second place to no one in extolling the virtues of competition and choice. However, those virtues need not come at the expense of the low price and high degree of reliability of electric service that all Americans have come to enjoy and expect.

Nevertheless, I caution against labeling the current situation as simply a "California problem." Nor is the problem one that is fleeting; it is not simply a "summer of 2000 problem." Rather, the problems that are now confronting Southern California represent a manifestation of larger, deeper problems that may confront other portions of the country in later months and years.

There is, unfortunately, no easy fix. Rebates, refunds, and emergency releases may offer some relief right now. However, these short-term bandages do nothing to mask the larger problem that surely will reemerge next summer and future summers until something is done to address the true, underlying nature of the problem. At bottom, the situation in Southern California demonstrates that the Federal Government – in particular, the Federal Energy Regulatory Commission, of which I am a Member – can and should do much more to promote energy supply, energy delivery, and utility innovation.

Regrettably, the Federal Government and the FERC have done little to address the issues of supply, delivery and innovation. There is no comprehensive energy strategy. Decisions are made on an expedient, ad hoc basis, with little regard for long-term impacts. And policies made in one energy sector (electricity, natural gas, oil, etc.) fail to take into account their impact on other sectors.

What is needed is a new form of thinking. Most regulators claim to support competition, but their decisions belie their stated intentions. What regulators need to do is to demonstrate the courage of their convictions by allowing competition actually to operate – by trusting that markets will make appropriate allocative decisions. Regulatory

policies that claim to help consumers by inhibiting the operation of market forces – such as through price controls – actually work to their detriment. Consumers will never truly enjoy the benefit of lower prices, enhanced service options, and unimpaired reliability until regulators make decisions that promote entry into competitive markets and capital investment in generating plants and delivery lines.

I now discuss my understanding of the problem as it applies to the United States as a whole and California in particular. I offer suggestions as to what the FERC can do to promote energy supply and deliverability and, thus, lower prices. While I appreciate and applaud the initiative of the Committee, I believe that the FERC already possesses considerable authority, without the need for additional legislative authority, to redress the problem at hand. What is needed most is political resolve, rather than political posturing, to do what is best for the American people.

A Nation-Wide Problem

Today's headlines, unfortunately, announce one type of energy crisis after another. Last winter, residents in New England experienced sharp increases in the price of home heating oil. Earlier this summer, automobile owners -- especially those in the upper Midwest -- faced gasoline prices in excess of $2.00/gallon. Natural gas inventories are down steeply and experts expect sharply higher natural gas prices this winter. There remains no political will to solve the issue of nuclear waste disposal.

To complicate matters, the FERC has demonstrated its reluctance to authorize, in a timely manner, the construction of natural gas pipelines to those portions of the country

that are particularly starved for gas supply. See Independence Pipeline Company, et al., 91 FERC ¶ 61,102 at 61,366-67 (2000) (Hébert, Comm'nr, dissenting). Moreover, the FERC is pursuing a hydroelectric dam decommissioning policy, of dubious legality, when it is not debatable that the Federal Power Act contains no such express authority. That policy threatens to tear down existing dams and complicate the already glacial process of dam relicensing. See State of Maine, 91 FERC ¶ 61,213 at 61,773-76 (2000) (Hébert, Comm'nr, dissenting).

The energy crisis of the moment concerns the price and reliability of electric service. Geographic pockets of the country are starting to experience disruptions in the price and delivery of electricity, just as competition is starting to open up markets and induce the participation of non-traditional utilities. Two summers ago, the Midwest experienced dramatic spikes upward (more than 100-fold) in the price of wholesale power. Last summer, several major metropolitan centers (New York, Chicago, San Francisco) experienced temporary blackouts when local delivery systems failed. This summer, southern California and, to a lesser extent, New York are experiencing price spikes of their own.

The underlying causes of these disruptions in electricity supply are many and are vigorously debated. What is certain is that reserve margins are shrinking, as a growing, computerized economy increasingly demands more power, and as electricity supply fails to keep pace. In addition to supply and demand disharmony, the nation's electricity

delivery system – millions of miles of transmission and distribution lines – increasingly is being stressed by competitively-driven transactions for which they were never intended.

In my three years of service as a FERC Commissioner, and for six years before that as Chairman and Commissioner of the Mississippi Public Service Commission, I have advocated a balanced approach. It is perfectly appropriate for federal and state governments to factor environmental considerations and landowner objections into their siting and certification decisions. Every form of energy production – whether based on fossil fuels or renewable fuels – has its attendant advantages and disadvantages. What is not appropriate is for regulators to summarily dismiss a form of energy production, through outright rejection or overly laborious procedures, without considering what alternatives will be available to meet demand. When a state blocks the siting and construction of generating plants or transmission lines, it needs to figure out how the energy demands of its consumers (and those of neighboring states) will be met. When the FERC blocks the construction of a natural gas pipeline or the development of a hydroelectric project, energy customers are all the more susceptible to the rigors of a fluctuating market.

(I discuss in a later section of my testimony what more the federal government can do to promote market entry, induce supply, and enhance deliverability.)

A California Problem

At this juncture, I can only speculate as to the principal causes of the sharp rise in electricity prices in Southern California. The FERC recently has initiated investigations

into wholesale electricity markets and practices, both on a nation-wide basis and on a California-specific basis. When presented with the reports of its investigative staff, the FERC can then determine what policies to pursue that can alleviate immediate pressures and can act, hopefully, to ensure that California and other regions do not experience similar crises on a regular or periodic basis.

At this time, however, I have four prime suspects: (1) California utilities; (2) the California Independent System Operator; (3) the California Public Utilities Commission; and (4) the FERC. We are certainly not without blame in Washington, D.C. This Administration has done little to promote, and nothing to develop, a positive energy policy, with adequate supplies and necessary investments, to give consumers choices of fuels and reasonable prices.

Electric utilities are starting to grapple with competitive choices and are developing a number of different corporate strategies. Some are proving more successful than others. While strategies may differ, all load-serving utilities should be expected to hedge their risks in certain respects. Utilities such as San Diego Gas & Electric Company that sell off their generating units are susceptible to market forces. Those that rely on the spot market, rather than entering into long-term power supply arrangements or capacity buy-backs, or purchasing financial instruments, are particularly susceptible. While my information is imperfect, it appears that SDG&E, for whatever reasons, may have exposed its ratepayers to considerable market risk by failing to employ adequate risk management techniques. If so, it would hardly be alone in failing to shield its ratepayers

from the whims of market forces. See New York Independent System Operator, Inc.; New York State Electric & Gas Corp. v. New York ISO, 92 FERC ¶ 61,073 at 61,315-18 (2000) (Hébert, Comm'nr, dissenting).

Though it employs capable people, the California ISO, as an institution, lacks the incentives and accountability to make difficult decisions necessary for the transition to competition. Most recently, we have seen the ISO compromise its independence. Bowing to pressure, it met over and over again until, against its own professional judgment, it adopted price caps that the ISO itself acknowledged will cause harm in the short and long term. Lowering price caps may look good but does not work. In fact, evidence not yet presented to the Commission may demonstrate that price caps during peak hours have the effect of raising rates during off-peak hours and, possibly, on an annualized basis. This is because suppliers that cannot recover their costs during peak hours must raise their bids during remaining off-peak hours. Thus, the decision by the ISO to adopt and lower price caps only makes matters worse and electricity more expensive for California ratepayers.

(This is not mere speculation. In a report dated September 6, 2000, the Market Surveillance Committee of the California ISO concludes that price caps have little ability to constrain prices. Specifically, it notes that monthly average energy prices in California during June of this year, when the price cap was $750/MWh, were lower than monthly average energy prices during August of this year, when the price cap was $250/MWh – even though energy consumption was virtually the same in both months .)

The problem of the ISO, however, goes back further. Over the years it has reached many decisions that make sense as politics, but not economics. FERC orders have found, among other things, that the ISO restricted imports without reason, encouraged suppliers to bid when prices would be the highest, and failed to penalize customers who understated their demand or generators that failed to deliver what they promised. In addition, the ISO mishandled congestion management by creating price zones that obscured the cost of locating in the wrong place. Like a political institution, it sought to spread the pain, and have other customers subsidize the high costs in congested areas. Most ISO filings state, not that it has adopted the right solution, but that it has reached a compromise that pleases all parties.

The California PUC deserves some attention for policies that fail to allow for the timely siting and construction of badly-needed generation. There is nothing wrong, of course, with the CPUC considering seriously the environmental consequences of new construction. It should. That intense consideration, however, comes at a cost. Suppliers are much less likely to enter California markets when the review process is uncertain and requires many difficult years of prior review and public input.

Moreover, the California PUC needs to reconsider regulatory policies that, in practice, fail to motivate its utilities to respond to the needs of their ratepayers. If SDG&E has no incentive to keep its wholesale costs down, and if it can act merely as a conduit by passing those costs on to its retail customers, without limitation, the utility has less of an incentive to engage in responsible risk management. The California PUC may

wish to consider performance-based measures of regulation similar to those I helped implement in Mississippi. Under policies adopted by the Mississippi Public Service Commission, utility earnings depend on the number and duration of interruptions, customer satisfaction (using actual complaints), and price. In response, Mississippi utilities have figured out how to set and meet reserve margins, safety standards, and capacity goals. In this manner, state regulators can better align private economic interest with the public interest.

Finally, much of the finger-pointing deserves to be directed at my agency. The FERC has been sending inconsistent signals to energy suppliers. On the one hand, it offers negotiated, market-determined rates to all suppliers who can demonstrate that they cannot exercise market power. On the other hand, it has signaled that it is willing to impose price controls and readjust bids if prices threaten to rise higher than anticipated. As a result, suppliers are wary of entering into markets that are not truly competitive – such as California – and if they cannot be confident of recovering a reasonable profit. The operators of peaking units – which are expensive and are intended to run only in periods of peak demand – are particularly disenchanted with pricing policies that may hinder their ability to recover the costs of operation.

Moreover, the FERC has been much too deferential to the operation of the California ISO that, as explained above, has hindered the operation of the competitive market. I have been willing to give ISOs, such as the California ISO, some time to commence operations and develop familiarity with competitive energy markets.

Unfortunately, with experience, ISOs have turned out to be flawed institutions that have proved successful only in perpetuating and expanding their bureaucratic reach.

In contrast, I believe that independent transmission companies (transcos) offer a vastly superior alternative. Because they are independent of other market participants, and have no incentive to favor any one particular source of supply, transcos offer truly non-discriminatory transmission service to market participants. Moreover, because they have a profit incentive to maximize transmission and throughput over their lines, transcos (unlike ISOs) have an incentive to operate their facilities efficiently and to expand their network when necessary to meet increased demand.

California needs new capacity, to feed a growing population and to meet the new demands of prosperity. It no longer needs a government institution – the ISO – that performs merely as a debating society, catering to all affected stakeholders. After three years of oversight under the ISO, which has focused short-sightedly on getting through the upcoming summer, rather than adding transmission and generating capacity, it is now time for California to turn to a different model. A transco, to be sure, just like any other business, operates to make money. But such a business model – rather than a governmental model – is what is needed to satisfy customer needs cheaply and quickly.

What the Federal Government Can Do To Address the Problem

As I already said, the FERC has done little to avoid the type of pricing and reliability problem we now see in California. If inclined to act decisively on electricity

pricing and reliability, there is much the FERC can do right now – without a single drop of additional legislative authority.

For starters, if the FERC is serious about increasing generation supply, it should act immediately to withdraw all price caps in generation markets. They distort price signals and inhibit entry into competitive markets. By facilitating efforts to minimize short-term price disruptions, and placing regulatory shackles on what should be competitive markets, the FERC is inhibiting precisely the type of investment in the grid that it should be supporting – and that is crucial to assuring true electrical reliability.

Another important means of enhancing reliability and promoting customer accountability is to give energy providers an incentive to provide reliable, efficient service. Conventional pricing methods provide no such incentive. It is my strong preference to afford utilities some type of performance-based measure of accountability to their customers and their regulators. Consistent with its existing authority, the FERC could – and should – tie earnings and profits to reliability-based and performance-based criteria.

Despite my urgings, the FERC has refused to adopt performance-based pricing measures of the type previously adopted in Mississippi. I was tremendously gratified when the FERC made its first tentative moves in this direction last winter, when it adopted its Order No. 2000 rulemaking on the development of regional transmission organizations. As the FERC explained, a RTO that meets the enumerated characteristics and functions – and that has demonstrated a commitment to promote grid reliability and

efficiency – will be eligible for a number of incentives. These incentives include performance-based rates, accelerated depreciation, and return on equity enhancements (formula and risk-based).

While I appreciate the FERC's baby steps on performance-based pricing, it will take awhile for RTOs to develop, win the FERC's approval, and qualify for innovative pricing. If it were up to me, I would adopt pricing measures now that would give both regional and individual electricity providers an incentive to minimize or eliminate service disruptions and to keep prices down, this summer and future summers.

I can think of numerous other measures the FERC can adopt to promote reliability and price stability, without delay and without additional authority conferred by Congress. The FERC could afford transcos an additional incentive to build transmission facilities by providing a higher rate of return on transmission assets. The FERC could articulate greater receptivity to proposals to build and invest in merchant transmission facilities. The FERC could pique additional interest in investment and corporate restructuring by allowing acquisition adjustments on the sale of transmission assets that confers benefits on ratepayers.

In addition, the FERC could greatly advance the cause of reliability by indicating its support for stand-alone transmission companies. As I have explained, a transco – much more so than any other type of regional institution or model – has a strong economic incentive to provide reliable, efficient and low-cost service. I wish the FERC would give a transmission company the chance to operate – and give an unequivocal

green light to other utilities that might be considering participation in similar for-profit ventures.

And the FERC – if truly committed to providing supply alternatives – could do much more to promote the development of hydroelectric facilities and the construction of natural gas transmission facilities. The answer to our nation's energy reliability needs lies not in the development of additional regulatory bodies and responsibilities – as the Administration, with the acquiescence of a majority of the FERC, now argues. Rather, the answer lies in promoting policies that encourage capital investment in all types of energy technologies and that allow competitive markets to operate as they should.

What the FERC should **not** do is now embrace calls for a return to cost-based regulation. Nor should the FERC encourage hybrid forms of rate regulation that graft cost-based ceilings on top of otherwise negotiated rates. In either event, suppliers would turn their back on California and investment would dry up. California increasingly would operate as an island amidst a sea of competition, and no longer would be able to turn outside the state for supply during times of peak demand. In addition, customers would lose a signal to conserve during periods of peak demand, and entrepreneurs would lose an incentive to develop and bring to market innovative, technological solutions (such as fuel cells, electricity storage, and other forms of distributed generation) to relieve capacity bottlenecks.

Rather, the FERC should follow its own example, when it refrained from adopting "retro" measures in response to the upward spike in Midwestern wholesale electric prices

during the summer of 1998. Numerous market participants and observers implored the federal government to do something, and to do something quick, to ensure that prices never rise to extreme levels again. Keeping a cool head, the FERC (as well as state commissions) instead focused its attention on determining whether any market manipulation or anticompetitive behavior had led to the price spikes. Finding none, the FERC decided to allow high prices to signal to suppliers that there is strong Midwestern demand for additional capacity. This is exactly what happened. Two years later, the Midwest has ample new supply of electricity and is now an exporter of power to other capacity-starved regions. Prices have stabilized, and reliability has remained unimpaired.

I encourage all regulators of California energy markets to adopt the same cautious, courageous, long-term approach.

What the Congress Can Do To Address the Problem

In the past year, I have had the privilege of testifying twice before Congress on the subject of electricity restructuring. On October 5, 1999, I testified before the House Commerce Subcommittee on Energy and Power on the subject of H.R. 2944, the "Electricity Competition and Reliability Act of 1999" (the Barton Bill). On April 27, 2000, I testified before the Senate Committee on Energy and Natural Resources on eight pending electricity restructuring bills.

Despite the events of the past summer, in California and elsewhere, my opinion has not changed on the subject of additional federal legislation. I continue to believe strongly that any new legislation should remove – not add – obstacles to the natural

evolution of the industry in the direction of competitive markets. As I have explained, what the FERC does need to do is to take decisive action under its existing authorization to promote capital investment in all forms of energy supply and delivery, and to enhance operational efficiencies.

Such action would benefit ratepayers in California and throughout the rest of the United States. There is no need for a California-specific congressional solution.

For this reason, I continue to believe that legislation is needed merely to repeal outdated laws of general applicability. Both the Public Utility Holding Company Act (PUHCA), dating from the Depression, and the Public Utility Regulatory Policies Act, dating from the Clinton Administration, act as serious brakes on utility restructuring. They stifle, rather than promote, competition. Similarly, there is no reason for the FERC to be in the business of reviewing electric utility mergers and to duplicate the efforts of the Antitrust Division of the Department of Justice and the Federal Trade Commission. FERC merger review, under section 203 of the Federal Power Act, brakes utility efforts to restructure themselves as they deem best to respond to and take advantage of competitive opportunities and challenges. More troubling, FERC uses mergers to further policy goals that it has no authority to order directly.

Beyond that, I do not see the need for additional legislative action. In particular, I do not see the need for the FERC to assume additional reliability authority. I favor business over government solutions to the issue of maintaining electric reliability in a restructured market. A quasi-governmental reliability organization, under FERC

oversight, and with FERC having last-resort authority to impose mandatory reliability standards on the industry, will operate no more effectively than any other quasi-governmental organization – such as the California ISO.

Instead, I prefer to advance market-oriented policies that offer incentives for badly needed investment. I favor injecting reliability standards in the performance-based rate plans I advocate for utilities. Specifically, I favor tying profits to performance. Each plan for each RTO would contain a target for reliable performance. An RTO's earnings would rise or fall on how well it meets its business plans (safe, reliable and low-cost service; maximizing transactions) and serves its customers.

Similarly, I do not see any need for additional FERC authority over "market power." Unlike some observers, I am not quick to assume an exercise of market power whenever price rises above marginal (operating) cost. FERC staff already possesses sufficient authority to investigate whether actual manipulation or collusion has led to high prices that are not justified by market conditions. (Indeed, this is what FERC staff is doing right now, in responses to unconfirmed accounts that market mis-behavior has led to high prices in California and elsewhere.) Should FERC staff detect improper or illegal behavior, the FERC (or, if appropriate, the Antitrust Division or the Federal Trade Commission) can craft an appropriate response.

Finally, I see no need to legislate rules governing the connection of generators to the grid. An RTO, especially a for-profit, stand-alone transmission company, has no reason to favor any particular source of generation. To the contrary, a transco, with an

economic incentive to push power over the grid, would welcome interconnection from as many generators as possible.

Summary of Testimony of
Hon. Curt L. Hébert, Jr.
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The recent rise in electricity prices in Southern California is, sadly, not simply a "California problem." Nor is it simply an aberrant, one-time, summer of 2000 problem. Rather, it represents the manifestation of a larger problem that, if left unchecked, surely will reemerge, perhaps with equal or greater severity, in other parts of the country during future months and years.

That problem is the failure of the current Administration and the federal government – including the Federal Energy Regulatory Commission – to commit itself to promoting the adequacy of energy supply and energy delivery. Competition in energy markets – which I vigorously support – cannot be successful if regulatory policies fail to ensure that supply will be available to meet surging demand. Without this equilibrium, breakdowns in energy markets inevitably will occur. California is merely one of the first.

What is needed – and is currently lacking – is a comprehensive plan that understands that **all** forms of energy production are vital to maintaining this country's energy needs. Regulatory policies that inhibit the construction of generating plants, transmission lines, natural gas pipelines, and hydroelectric facilities are counterproductive. So too are regulatory policies that fail to commit to competition in emerging markets for energy products.

Now is **not** the time to second guess the competitive evolution and corporate restructuring of the electric industry. Competition is coming, whether regulators and legislators like it or not, because customers increasingly are demanding a say in the selection and pricing of energy services. Recent price spikes in California should not be embraced as an excuse to return to decades-old, cost-based, command-and-control regulation. Nor should recent events motivate regulators to graft price ceilings on top of otherwise market-oriented, negotiated prices.

What recent events should teach us is that consumers are not served when uncertain regulators and legislators adopt hybrid, part-competitive/part-regulated models. The answer to today's problem is not to impose additional layers of quasi-governmental bureaucracy between energy suppliers and energy consumers. Rather, the answer is to move quickly to business solutions and models (such as independent transmission companies) that will, finally, give energy suppliers the motivation they need to listen to their customers and to serve them effectively.